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The Internal Revenue Service's Free File Program (FFP): Current Status and Policy Issues

The option to electronically file (e-filing) federal individual income tax returns began in 1986. Since then its usage has grown considerably. As of the end of December 2020, 89% of returns for the 2019 tax year were e-filed. Nonetheless, 17.6 million paper returns were filed for that year.

As a policy matter, the IRS would like to achieve an e-filing rate of 100% because of its advantages over paper filing. Generally, e-filing has a lower cost for processing returns and reduced error rates. E-filing also speeds up the processing of tax refunds for individuals who had too much income tax withheld or overpaid their tax during a year.

An element of the IRS's strategy to promote e-filing is the Free File Program (FFP). The program permits individuals with adjusted gross incomes (AGIs) at or below a specified amount (\$72,000 for the 2020 tax year) to electronically prepare and file their federal income tax returns, free of charge, using software provided by participating tax software companies, which totaled nine companies at the start of the 2021 filing season. The IRS provides a direct portal on its website for qualified persons to file through the FFP.

Since its creation in 2002, the FFP has sought to achieve three goals:

- Simplify tax preparation and filing for “economically disadvantaged and underserved” taxpayers;
- Provide more services to taxpayers who normally file paper returns; and
- Encourage further growth in e-filing by giving lower-income taxpayers the opportunity to file their returns free online through software provided by tax software companies.

Origin of the FFP

The FFP has its origin in two sources. One was the IRS Restructuring and Reform Act of 1998 (RRA, P.L. 105-206). Among other things, the RRA directed the IRS to increase the share of e-filed individual returns to 80% by 2007, with assistance from the private sector. Achieving this goal posed a significant challenge for the IRS, as the e-filing rate was 23.5% in the 1998 tax year.

The second source was a directive issued in 2001 by the Office of Management and Budget's (OMB's) Quicksilver Task Force to implement President George W. Bush's E-Government Initiative. One of the 24 initiatives chosen by the task force was the EZ Tax Filing Initiative. Its main purpose was to help the IRS reach its 80% e-filing goal by

2007 by making electronic tax preparation and filing more accessible to paper return filers without requiring them or the federal government to pay for commercial tax services. The key to success, senior Treasury officials thought at the time, was for the IRS to establish a “single point of access” for lower-income taxpayers to free online tax preparation and filing services provided by tax software companies. (The IRS did not achieve its 2007 e-filing goal until 2012, when 83% of individual returns were e-filed.)

As a first step in implementing the EZ Tax Filing Initiative, the IRS tried to develop a digitized version of Form 1040 and accompanying schedules and instructions that could be accessed at no cost through WhiteHouse.gov. It soon became apparent that the IRS lacked the resources and experience needed to efficiently launch such a project. To circumvent these obstacles, in January 2002, Treasury Secretary Paul O'Neill asked IRS Commissioner Charles Rossetti to form a partnership with tax software companies to develop a system for providing free online tax preparation and filing services for lower-income taxpayers. The resulting private-public partnership was known as the Free File Alliance (FFA).

Structure and Evolution of the FFP

The FFP began when the IRS signed an agreement with the 17 original FFA member companies on October 30, 2002.

From the start, there was a clear division of authority and responsibility between the IRS and the participating companies.

The initial agreement required the companies to make available at no cost their tax preparation and filing software through IRS.gov to at least 60% of taxpayers ranked by AGI. The companies retained complete control over the scope of their free-file services and eligibility requirements, with one exception: each member company had to be capable of providing free filing services to cover at least 10% of individual tax returns filed for a year.

The IRS was responsible for enforcing member company compliance with the terms of the agreement. As a result, the agency was authorized to cancel the agreement with one year's advance notice, if it determined that the companies, over an extended period, were failing to provide adequate or required coverage.

A key component of the agreement arguably involved a trade-off between access to e-filing for paper filers and the potential benefits of the IRS creating a direct filing option for all taxpayers. The IRS pledged not to compete in the market for tax software. In return, member companies

agreed to offer free electronic tax preparation and filing services to low- to middle-income taxpayers. This meant that the IRS could not develop prefiled tax forms and make them available at no cost to taxpayers through a secure portal on its website.

The IRS and the FFA have extended and revised the original agreement five times. These subsequent agreements are linked to nine memoranda of understanding (MOU), which apply to specific tax filing seasons.

The second agreement (2005) reduced the range of free services a company could offer to eligible taxpayers, limited the share of eligible taxpayers a single company could serve to 50%, and increased the share of taxpayers eligible for free filing through the FFP to the bottom 70% of individuals ranked by AGI.

The 2009 agreement expanded the scope of the FFP by adding free fillable individual income tax forms to the services available through the program. Taxpayers of all income levels were eligible to file using these e-forms. The 2009 agreement also required FFA companies to embed a link to IRS.gov in their landing pages for the FFP.

The current agreement (2018) is due to expire on October 31, 2021. It includes steps intended to raise taxpayer awareness of the program, encourage eligible taxpayers to use it repeatedly, and prevent participating companies from excluding their Free File landing pages from internet searches for the FFP. Companies that engaged in this practice benefited from it, because taxpayers accessing their websites to file through the FFP were referred to pages featuring the companies' paid services before they were informed that they could file at no cost through the FFP.

The MOU adopted in 2019 to implement the 2018 agreement was notable for its lack of a prohibition on the IRS developing its own software for free tax preparation and a filing system through a secure portal on the IRS website. Each previous MOU had contained such a provision.

Use of the FFP

A continuing concern about the FFP from its start has been its low usage. In FY2003, the first year of the program, 2.8 million individuals filed their tax returns through the FFP, representing 3.5% of all eligible taxpayers. Use of the program peaked in FY2005, when 5.1 million individuals (or 6.4% of eligible taxpayers) filed through the FFP. Since then (except for 2009), FFP use has mostly declined. Of the 154.1 million individual tax returns filed in FY2019, 2.8 million were filed through the FFP (2% of eligible taxpayers).

Policy Issues

In the 116th Congress, discussion of the FFP focused on whether to codify the program and to permit the IRS to develop its own competing software. In April 2019, the House passed a bill (Taxpayer First Act, H.R. 1957) to reform various aspects of how the IRS interacts with taxpayers; it included a provision that would have

permanently extended the FFP. The provision triggered an outpouring of dissent from several groups, including some Members of Congress concerned about the ways in which member companies had used the FFP to expand their revenue. The 116th Congress ended up passing a similar bill, but without the FFP provision (P.L. 116-25).

The debate over codifying the FFP has shed light on the effectiveness of the FFP, its shortcomings, and ways to improve the program.

FFP proponents say it should be retained in its current form because it saves low- and middle-income taxpayers and the IRS considerable money each year. According to the FFA, taxpayers saved an estimated \$1.5 billion from 2003 to 2018 as a result of the option to file free under the FFP. In the same period, the FFA claims that the program has saved the IRS hundreds of millions of dollars in processing costs.

By contrast, FFP critics contend that the current program is too flawed to achieve its main goals. Of particular concern are the ways in which participating companies have used the program to enlarge their revenue base. This expansion, say critics, is the result of the ban on IRS competition in the market for electronic tax preparation and filing, as well as efforts by member companies to market their paid services to taxpayers eligible for the FFP. Critics cite several other reasons to explain why the FFP has been ineffective. They are (1) complexity of the companies' websites for FFP filing; (2) the program's historically low take-up rate; (3) inadequate promotion of the program by the IRS; and (4) program goals that have remained unchanged since 2003.

Options for Reforming the FFP

The alleged shortcomings of the FFP have led some to call for changes in the program. Among the options being considered, two general approaches have emerged.

One approach would retain the FFP but require the IRS to invest more in promoting it among eligible taxpayers and to closely monitor member companies' compliance with the MOU. Among the ways to strengthen the IRS's oversight of the FFP, the MOU could be revised to require member companies to disclose the amount of revenue they receive from marketing their paid services to FFP-eligible taxpayers.

Another approach would replace the FFP with a system that eases the tax preparation and filing burden for taxpayers with relatively simple tax situations. Under such an option, taxpayers might prepare and file their returns through a secure portal on the IRS website; or the IRS might prefill returns for individuals whose income and deductions are reported to the IRS by third parties, and then send them to taxpayers for their review and acceptance; or the federal government might adopt a return-free filing system based on exact withholding or tax-agency reconciliation.

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